

## SEPTEMBER 2009 NEWSLETTER

Hi John,

**The good the bad and the ugly**

*It felt like someone had just died a tragic and untimely death.*

To read an account by a junior Lehman Brothers M&A banker who watched the collapse unfold in 2008 [click here](#) Or for those of you who like videos [click here](#) for the downfall and [here](#) for the aftershock.

**Lehman Brothers anniversary**

Much has been said in the news about the collapse of Lehman Brothers and its aftershock so I won't go into it in detail here. But the video clip above is worth while looking at if – like me - you're fascinated by this stuff.

It's interesting to look back on what's happened to the financial markets in New Zealand since then. The initial shock wasn't too bad. But when globally banks stopped lending to each other, and the commercial paper markets in the U.S. and the U.K. ceased to function completely, there was almost a month when New Zealand banks could not raise any cash in the offshore markets. Adam Bennett's article the Herald sums it up pretty well. To read it [click here](#) Actually things started going bad in the finance sector here well before that. It started in May 2006 when the first finance company, National Finance, collapsed. Then in July 2007 there was the big one, Bridgecorp, and by the end of September 2007 ten finance companies had disappeared.

It was in the April 2007 GLOBAL VIEW that I first mentioned the concerns in the U.S which became known as the sub-prime crisis and which eventually led to the worldwide financial meltdown that occurred when Lehman Brothers filed for bankruptcy on 15 October 2008. To see this issue [click here](#)

In it there was a link to an excellent article on that subject by Neville Bennett (which unfortunately doesn't link through now) so it's appropriate that I refer to a recent article by Neville called "A tumultuous year".

In it he says "*Credit is the lifeblood of an economy. In this way a financial crisis was immediately changed into a major economic crisis*".

He goes on to say "*The economic situation has been stabilised by central bank and government intervention. The level of global industrial activity has turned positive for the first time since May 2008.*" To see the article [click here](#)

Confidence has returned to the global economy. Two significant events out of the U.S. are typical. One when the Federal Reserve chairman Ben Bernanke told a Washington think tank "*From a technical perspective, the recession is very likely over*" and the other when the Sage of Omaha, Warren Buffet, said he was buying U.S. shares again.

For some charts showing progress in the major markets since then [click here](#)

Here in New Zealand the recent BNZ confidence survey revealed 56% of respondents felt the economy would improve over the coming year – compared with 42% in August and only 15% in July.

Even our Treasury's got into the act when they said there are signs the housing market and the wider economy is beginning to grow again and unemployment was unlikely to reach 8%. For the National

Business Review article [click here](#) They've even revised their previous prediction average house prices would fall by 10%. To see their view of housing market developments [click here](#)

Yes the housing market – the leader of economic recovery here – continues to improve. Property values rose for the fourth month in a row and New Zealand has ranked in the top 10 housing markets in the world.

Westpac chief economist Brendan O'Donovan said at the recent Trans Tasman Credit Summit in Wellington, *"New Zealand's recovery from recession will be fuelled by a migration-driven housing construction boom, with Auckland leading the way."* To read the Herald article [click here](#)

### ***But the credit crunch still hasn't gone away***

There is however a fear that the stimulus packages governments have put in place may not be as effective as was hoped and credit remains hard to get.

In the U.S. Professor Tim Congdon from International Monetary Research said bank loans have fallen at an annual pace of almost 14% in the three months to August. *"There has been nothing like this in the USA since the 1930s,"* he said. *"The rapid destruction of money balances is madness."*

Mr Congdon said a key reason for credit contraction is pressure on banks to raise their capital ratios. While this is well-advised in boom times, it makes matters worse in a downturn. *"The current drive to make banks less leveraged and safer is having the perverse consequence of destroying money balances,"* he said. *"It strengthens the deflationary forces in the world economy. That increases the risks of a double-dip recession in 2010."* To read the article [click here](#)

It's the same here. Most finance companies have disappeared, many of the mortgage trusts are gradually being wound up, banks and non-bank lenders alike are hoarding funds to ensure loans that cannot be repaid or re-financed due to the economic conditions can be renewed, and some lenders like Marac have withdrawn from property lending completely. South Canterbury Finance is pretty much out of the market as it seeks to raise more capital.

The banks here have been under criticism too. Customers are complaining interest rates are too high, costs are increasing, credit is getting less accessible and the banks are using any change in facility to seek additional guarantees.

The last point is significant. Banks are notorious for cross collateralising all assets owned and this can lead to problems in a downturn. For example, on the sale of an asset the equity released being retained by the bank to bring other assets owned within new guidelines they require.

I am constantly being approached to finance acquisitions outside the applicant's normal banking channels or to refinance other assets elsewhere.

Tony Alexander sums it up pretty well in his latest BNZ Weekly Overview where he says *"credit availability has not only tightened for farmers but for practically all borrowers as a result of the global financial crisis revealing inadequate risk assessment by lenders to banks, inadequate prudential supervision in some countries, and in NZ the severe erosion of the finance company sector. Reduced credit availability is likely to strongly limit growth in areas which have traditionally relied upon high risk lenders – such as property development."*

### ***Commercial property and business***

The credit crunch and the recession have affected commercial property here in a number of ways.

- Business slowdown has meant tenancies are not being renewed, vacancies are higher, and landlords are being forced to do deals. Paul Duffy, chief executive of the \$746 million DNZ Property Fund, told shareholders in Auckland at the inaugural annual meeting of the revamped business, that leasing incentives on investment properties were rising. To see the Herald article [click here](#)
- Properties in the \$1 - \$5 million range with multiple tenants are selling at low yields (high

prices) as private cashed up investors seek better returns than they can get at the bank.

- Larger office only buildings are suffering. The institutions are out of the market as they readjust their asset allocations between equities, property and bonds. The Australian institutions flush with compulsory superannuation funds have remained silent as they pay attention to their own problems at home.
- Lenders are paying more attention to the type of tenants, their strength, and the length of the leases.

With few finance companies in the market businesses in leased premises are hard to fund. For all the talk about cash flow lending, banks are still seeking property as their main security.

However amongst all this kerfuffle loans are available. It's a matter of knowing where to go and presenting the proposal in the best possible manner.

### **Interest rates**

A week or so ago the New Zealand Reserve Bank decided to keep the Official Cash Rate at 2.5%. In his speech Governor Alan Bollard said *"As we have said previously, the forecast recovery in economic activity is based on monetary policy continuing to provide substantial support to the economy. We expect such support will be needed for some time. As a result, we continue to expect to keep the OCR at or below the current level through until the latter part of 2010."*

The banks have been under some criticism for not reducing interest rates in line with the reductions in the OCR. But now the competition seems to be increasing and in the last couple of weeks the banks have been reducing rates aggressively. The BNZ is the latest to join the fray now claiming the lowest floating home loan rate of 5.59%.

The average OCR since 1999 is 6% and the average floating residential mortgage rate over the last 10 years is 8.5%. The question is of course when will the Reserve Bank return the OCR to the average and at that time what will floating rates be?

Well who knows? But Rodney Dickens is of the view there will be a much stronger economic recovery than the Reserve Bank is predicting and it's likely the OCR will be raised in the first half of 2010 rather than the second. To subscribe to Rodney's excellent publications [click here](#)

In my view we are going to see short term rates rise sooner than expected and longer term rates stabilise as the margins banks pay for wholesale funds narrows with the global recovery.

### **Exchange rate**

In the July GLOBAL VIEW I said don't rely on the dollar going down and put links to some excellent articles on the currency by Tony Alexander and Rodney Dickens in it. To see that issue [click here](#)

Last week the US/NZ exchange rate hit a 13 month high to over 71 cents. And it wasn't just the U.S. dollar – it reached a 12 year high against the British pound. To see the NBR article [click here](#)

The reasons given are generally around a weak U.S. dollar which is seen to be under pressure since the Fed there started the stimulation programme of quantitative easing or - as many people see it - printing money.

But I think it's more than that. The reality is New Zealand and Australia are seen as a safe havens, with stable banks, in a world reeling from the worst recession in 80 years.

New Zealand is seen as a safe place to invest by Dun & Bradstreet's Asia-Pacific Risk Indicator survey. New Zealand general manager John Scott said *"New Zealand's low investment risk has seen the Kiwi dollar appreciate 25% since March as the country's economic and political environments provide a degree of stability"*. To see the article [click here](#)

An August newsletter from Infometrics entitled, The exchange rate – the symptom, not the cause, points out the New Zealand Trade Weighted Index sits around 62 which is close to its average since 1985. *"In a world where commodity prices are recovering, uncertainty is melting away, and many of our trading*

*partners have experienced sharper declines in economic activity, the New Zealand dollar appears fairly priced” they say.*

And according to Westpac economist Dominick Stephens, the New Zealand dollar may even extend its gains against the Australian dollar as our export commodities outperform and inbound migration strengthens the economy. He says it may even reach 84 cents Australian this year. To see the Share Chat article [click here](#)

In my view the US/NZ range of 50 – 60 cents in the 90s is more likely to be in the 60 – 70 cent range this decade.

Cheers

JP



John Paine  
Global Pacific Corporation Limited  
112 Gladstone Road, Parnell,  
P O Box 3229, Auckland, New Zealand  
Phone +64 9 303 3700, Fax +64 9 303 3031  
Mobile +64 21 902 004  
Email [john.paine@globalpacific.co.nz](mailto:john.paine@globalpacific.co.nz)  
Web site [www.globalpacific.co.nz](http://www.globalpacific.co.nz)

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